

# NOTE

## *Mahler v. Szucs*: An Impediment to Interinsurer Arbitration and Affordable Personal Injury Protection Coverage

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### I. INTRODUCTION

Insured drivers who are never in accidents frequently complain that they will see little, if any, of the money they pay in premiums. Truly, most people who are insured under all types of policies will pay a substantially greater amount than they will ever recover. In light of the common idea that insurance companies are bottomless money pits, into which insureds eternally pay their hard-earned dollars with no pay-off, premium-payers find it easy to rationalize abuses of the institution of insurance. Indeed, little sympathy is felt for the faceless insurance company when an individual succeeds in getting a piece of the pie. This mindset, however, is nothing but pervasive self-deception. On an aggregate level, tolerating such abuses only cheats the ultimate foundation of the insurance industry: its premium-paying insureds.

Insurance is our way of dealing with risk, uncertainty, and factors that are beyond our control.<sup>1</sup> This observation is especially evident in the realm of auto accident insurance. A driver can exercise

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1. See ROBERT E. KEETON, INSURANCE LAW § 1.2 (1971) [hereinafter KEETON, INSURANCE LAW].

extreme caution and care in driving on the roadways and still find herself the victim of a serious accident for reasons beyond her control, such as the negligence of other drivers or unforeseeable weather conditions. Hence, because drivers and other insureds cannot effectively eliminate the probability of loss, they limit the possible economic effects of loss at a cost to everyone through insurance, simultaneously gaining the contentment of peace of mind.

#### A. *The Transactional Costs of Loss Recovery from Insurers*

While it is true that most policyholders pay more in insurance premiums than they will ever recover from an insurer, those who do recover often recover much more than they will ever pay. Thus, in this system of risk management, the majority of policyholders subsidizes both the cost of the actual loss incurred by the minority of policyholders and the transactional costs associated with the minority recovering that loss. To the extent that either of these costs can be reduced, the majority will benefit by having to subsidize a reduced amount of other people's losses, resulting in lower average premiums. Again, the cost of the actual loss is beyond anyone's control. The transactional costs, however, such as the cost of recovering subrogated interests<sup>2</sup> amongst insurance companies themselves, are within the control of insurance companies to some extent, and their efforts to reduce those transactional costs are worthwhile.

#### B. *A Factual Scenario*

As an illustration of the desirability of reducing transactional costs in insurance, consider the hypothetical case of Ms. Hurt, who is injured in an automobile collision by Mr. Liable, a tortfeasor insured

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2. A subrogated interest refers to an interest created by "an equity called into existence for the purpose of enabling a party secondarily liable, but who has paid the debt, to reap the benefit of any securities or remedies which the [tort] creditors may hold against the principal debtor [in tort] and by the use of which the party paying may thus be made whole." WILLIAM R. VANCE AND BUIST M. ANDERSON, HANDBOOK ON THE LAW OF INSURANCE § 134 at 787 (1951) (quoting *St. Louis, I.M. & S. Ry. Co. v. Commercial Union Ins. Co.*, 139 U.S. 223 (1891)). The right of subrogation exists, then, when a party, the subrogee, pays another's obligation for which it has no primary liability, and this right of subrogation protects the subrogee's own rights and interests. *Millers Cas. Ins. Co. v. Briggs*, 100 Wash. 2d 9, 13-14, 665 P.2d 887, 890 (1983). When an insurer has a subrogation interest, for purposes of a claim involving that interest it has the same rights as the insured injured party. *Touchet Valley Grain Growers, Inc. v. Opp & Seibold Gen. Constr. Inc.*, 119 Wash. 2d 334, 341, 831 P.2d 724, 728 (1992). Thus, when an insurer pays its insured who has become injured in some way, the insurer, through a subrogation clause in its policy with the insured, has a subrogation right with respect to the amount it has paid. It then has a lien on any of that amount subsequently recovered by its insured from the liable party.

under an auto liability policy.<sup>3</sup> As a result of the accident, Ms. Hurt incurs significant medical expenses that require immediate payment, and she is able to pay for those expenses through her own Personal Injury Protection (PIP) insurance policy<sup>4</sup> with ABC Insurance Company. A portion of Ms. Hurt's PIP policy reads as follows:

d. If the insured recovers from the party at fault and we share in the recovery, we will pay our share of the legal expenses. Our share is that percent of the legal expenses that the amount we recover bears to the total recovery.

This does not apply to any amounts recovered or recoverable by us from any other insurer under any interinsurer arbitration agreement.<sup>5</sup>

The PIP policy will cover Ms. Hurt's medical expenses and temporarily compensate her for any loss in wages if she is forced to stop working, but it will not compensate her for any pain and suffering she experiences. Therefore, Ms. Hurt hires her own attorney, who will be compensated by way of a contingent fee agreement under which he is paid one third of the entire recovery. Ms. Hurt hopes to recover general damages<sup>6</sup> from Mr. Liable under his liability insurance policy with XYZ Insurance Company, which is a signatory to an interinsurer arbitration agreement with ABC.

Ms. Hurt's attorney notifies ABC Insurance that he is representing Ms. Hurt and acknowledges that ABC has a right to be reimbursed for the PIP payments it has made. However, ABC responds that it intends to recover those payments through the interinsurer

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3. This hypothetical parallels the facts of *Mahler v. Szucs*, 135 Wash. 2d 398, 957 P.2d 632 (1998).

4. Personal Injury Protection (PIP) is first-party insurance, meaning that it pays benefits to the insured herself when she becomes injured. See ROBERT H. JOOST, *AUTOMOBILE INSURANCE AND NO-FAULT LAW* 2D § 2:3 (1992). PIP coverage should be distinguished from liability coverage, which is third-party coverage, meaning that it compensates some person other than the insured for damages caused by the insured. See *id.* § 2:5. In 1987, twenty-nine percent of the automobile injury claims in the United States that were paid from automobile insurance sources were paid under PIP coverage, whereas forty-seven percent were paid under liability coverage. See *id.* § 2:2 (citing All-Industry Research Advisory Council (AIRAC), *Compensation for Automobile Injuries in the United States* 6 (1989)).

5. This exclusionary policy language is identical to that in the policy held by the plaintiffs in *Mahler*, 135 Wash. 2d at 419, 957 P.2d at 643.

6. General damages have been distinguished from special damages on the ground that they need not be claimed or mentioned in the complaint in order to be the subject of proof and recovery at the trial. This distinction is based on the proposition that general damages necessarily flow from the breach of duty of care, whereas special damages are specific proximate results that do not flow as a matter of necessity from the breach. See generally CHARLES T. MCCORMICK, *DAMAGES*, § 8 (1935). In this case, general damages refers to compensation for pain and suffering and long-term loss in income resulting from permanent disability caused by the defendant's negligence, which necessarily flow from the liable party's negligent operation of an automobile.

arbitration agreement between it and XYZ, which is referenced in the policy above. ABC thus advises Ms. Hurt's attorney to do nothing to recover its PIP payment interest. Ms. Hurt's attorney litigates with XYZ and reaches a settlement. However, because Ms. Hurt's attorney has had to document Ms. Hurt's medical expenses in order to prove the existence of her pain and suffering, the settlement he arranges consists of both the medical expenses that have already been paid for by ABC and Ms. Hurt's general damages for pain and suffering. Given the clause noted in the PIP policy held by Ms. Hurt with ABC, should ABC Insurance Company have to pay part of Ms. Hurt's attorney fees in this situation? In *Mahler v. Szuchs*, the Washington Supreme Court recently decided that it must.<sup>7</sup>

This Note will demonstrate that the *Mahler* court's decision will lead to inefficient results, because it has essentially compelled PIP insurers to accept representation by attorneys who have a conflict of interests, precluding such insurers from selecting the best means of recovering their PIP interests. As a result, the price of insurance premiums inevitably will escalate, while providing plaintiffs' attorneys with a windfall of increased fees for performing no additional work for their clients. The following discussion will show not only that the *Mahler* court holding is inefficient as a matter of public policy, but also that its analysis ignores a body of Washington case law that suggests the opposite conclusion should have been reached as a matter of legal precedent.

The remainder of this section discusses the specific facts of the two cases that comprise *Mahler* in its consolidated form. Section II discusses fundamental principles of insurance law and economic efficiency and the manner in which the Washington courts have adopted these principles. Finally, Section III contrasts the implications of *Mahler* with these principles and with Washington precedent to show that the decision is both inefficient and contrary to the rationales of prior case law.

### C. *The Facts of the Consolidated Cases of Mahler v. Szuchs and Fisher v. Aldi Tire, Inc.*

The Washington Supreme Court recently decided that an insurer must pay reasonable attorney's fees when an insured recovers its PIP interest in a situation like Ms. Hurt's.<sup>8</sup> In essence, the court created an entitlement in plaintiffs' attorneys to collect a portion of a PIP insurer's payment interest when they recover such an interest pursuant

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7. See *Mahler*, 135 Wash. 2d at 436, 957 P.2d at 652.

8. See *id.*

to a settlement with the liability insurer. The respective plaintiffs, Mahler and Fisher, similar to Ms. Hurt in the above scenario, recovered amounts from liability insurers that they had to hand over to their PIP insurer, which happened to be State Farm Insurance Company in both cases. The language in the State Farm PIP insurance policies held by both Ms. Mahler and Ms. Fisher was identical to that in the scenario above,<sup>9</sup> clearly indicating that in the event that it could recover such interests via interinsurer arbitration, it would not have to pay attorney's fees for recovering those interests.

In the first of Mahler's two consolidated cases, Dr. George Szucs injured Elaine Mahler in an automobile collision.<sup>10</sup> Ms. Mahler hired her own attorney to seek general damages, similar to Ms. Hurt in the example above.<sup>11</sup> After her attorney notified State Farm that he was representing her, State Farm responded that he should "take no action whatsoever in connection with the recovery of State Farm's claim against the adverse party or insurance company."<sup>12</sup> However, Mahler's attorney ignored this instruction, electing to collect State Farm's PIP interest along with general damages. Nevertheless, he demanded that State Farm owed him for recovering that interest.<sup>13</sup> In response, State Farm declared that it would "not accept having [the attorney's] services unilaterally forced upon [it] for a fee that [it had] not agreed to."<sup>14</sup>

Mahler's attorney retained the recovered PIP payments in his trust account and filed a series of motions seeking a declaration that State Farm owed him an attorney's fee credit against that amount.<sup>15</sup> Finally, after a mandatory hearing, an arbitrator awarded Mahler's attorney the credit against the PIP payment funds in his trust account.<sup>16</sup> State Farm was then granted a trial *de novo*, and on cross-motions for summary judgment in superior court, Mahler's attorney was awarded a similar offset for recovering State Farm's PIP payment interest.<sup>17</sup> The court entered no findings of fact or conclusions of law to support the award.<sup>18</sup> Mahler and State Farm then sought direct

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9. *Id.* at 419, 957 P.2d at 643.

10. *Id.* at 405, 957 P.2d at 637.

11. *Id.* at 406, 957 P.2d at 637.

12. *Id.*

13. *Mahler*, 135 Wash. 2d at 407, 957 P.2d at 637.

14. *Id.* (quoting State Farm's letter to Mahler's attorney).

15. *Id.* at 407, 957 P.2d at 638. The recovered PIP payments amounted to \$4,173.32. The attorney's fee credit claimed against those PIP funds amounted to \$1,391.10.

16. *Id.*

17. *Id.* at 407-08, 957 P.2d at 638.

18. The Superior Court awarded Mahler \$1,612.59 as an offset. *Id.*

review to the Washington Supreme Court, and the case was consolidated with Fisher's.<sup>19</sup>

Fisher's case involved a truck insured under a liability policy held by Aldi Tire, Inc., which injured Monica Fisher in an automobile collision.<sup>20</sup> Fisher likewise hired her own attorney to obtain general damages, but neither Fisher nor her attorney notified State Farm that Fisher intended to litigate State Farm's PIP interest until Fisher's attorney had nearly reached a settlement with Aldi Tire's insurer, Federated Service Insurance Company.<sup>21</sup> At that time, Fisher's attorney likewise demanded that State Farm pay him for recovering its PIP payment interest.<sup>22</sup> Again, State Farm refused to pay fees for services to which it had never agreed.<sup>23</sup>

Upon settlement with the liability insurer, Fisher requested and the court ordered that the amount of State Farm's PIP interest be placed in the registry of the court so that the settlement agreement could otherwise be executed.<sup>24</sup> Fisher then instituted a complaint in interpleader to decide the issue of attorney's fees, and, on cross-motions for summary judgment, the court ruled that the entire amount would be disbursed to State Farm without any payment to Fisher.<sup>25</sup> Fisher appealed and the Court of Appeals reversed and remanded for a factual inquiry as to whether the PIP payment interest was actually "recoverable" under State Farm's exclusion clause.<sup>26</sup> On remand, the trial court granted State Farm's summary judgment motion, holding that the PIP payments were "recoverable" under the exclusion but for the interference of Fisher's attorney.<sup>27</sup> Fisher and

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19. *Id.* at 408, 957 P.2d at 638.

20. *Id.*

21. The court indicates that "[s]ix months before Fisher filed a complaint against the tortfeasor, State Farm wrote her a letter, with a copy to her attorney, saying, 'If you should recover our [First Party Benefit payments] from the responsible party or their [sic] insurance carrier, you must protect our reimbursement rights,'" noting that Fisher's attorney then "exerted significant efforts to establish liability." *Id.* at 408-09, 957 P.2d at 638. However, note that not until "[t]wo years later, with the case set for trial, [did] Fisher's attorney [inform] State Farm that after doing everything 'but hammer at the gates of hell,' he was close to settlement" of both general and special damages. *Id.* at 408-09, 957 P.2d at 638-39. Thus, Fisher's attorney demanded attorney's fees without having provided any kind of notice to State Farm that he intended to recover its interest. The letter from State Farm merely warned that if its interests were recovered by Fisher, its reimbursement rights must be protected. The letter was not a solicitation by State Farm for Fisher's attorney to actually collect that interest. *Id.* at 407, 957 P.2d at 637.

22. *Id.* at 409, 957 P.2d at 639.

23. *Id.*

24. *Id.* at 410, 957 P.2d at 639.

25. *Id.*

26. *Id.* The Court of Appeals concluded that whether the PIP payments were actually "recoverable" through the process provided in the arbitration agreement was an issue of fact to be determined by the trial court. *Id.*

27. *Id.* at 411, 957 P.2d at 639.

State Farm likewise sought and were granted direct review to the Washington Supreme Court.<sup>28</sup>

## II. PRINCIPLES OF INSURANCE AND THE LAW OF WASHINGTON

### A. *Involvement of Attorneys in Loss Recovery and Increased Transaction Costs*

Attorneys' fees account for a significant portion of the transactional costs involved in loss recovery. A 1987 study conducted by the All Industry Research Advisory Council (now known as the Insurance Research Council) and a 1988 study conducted by the National Association of Insurance Commissioners (NAIC) revealed significantly higher premiums in states where a greater number of personal injury claimants were represented by attorneys.<sup>29</sup> This empirical study comports with the theoretical notion that where attorneys are involved in recovering an insured's interest, the costs of recovery will be higher because of the increased transactional costs that attorneys necessitate.

Of course, whether an insured will exercise her right to counsel is a matter beyond anyone's control but the insured herself, and rightly so. The limitation of attorney participation in loss recovery can only be imposed when, as in *Mahler*, both parties are insurers who have agreed contractually, through an arbitration agreement, to resolve their disputes without resort to the judicial system. Such an arbitration agreement is practical and sensible, given the frequency with which insurers have routine claims against one another. Thus, inter-insurer arbitration clauses are an effective effort to reduce transactional costs when two insurers have a dispute that can be resolved without the active involvement of their insureds.

As a final comment on economic efficiency, consider the importance of free choice in determining the most efficient course of action for a corporation, such as an insurance company. As the following discussion reveals, insurers find themselves with various interests and a range of methods for pursuing those interests. Because an insurer is the best judge of its own costs and seeks to minimize those costs, it will seek to determine, often by trial and error, which method or plan of pursuing its interests is the least costly to utilize. The insurer may even determine that not pursuing an interest is the most cost-efficient choice if its resources are better utilized in some other fashion. To foster economic efficiency, the government or the courts should

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28. *Id.*

29. See ROBERT H. JOOST, AUTOMOBILE INSURANCE AND NO FAULT LAW 2D § 10:16 (1992).

impose limits on the insurer's choices only when some vital public policy justifies such a restriction.

*B. Personal Injury Protection (PIP) Policies and  
Their Enforcement Mechanisms*

The various means by which an insurer can enforce its interests under a PIP policy dominate the *Mahler* court's decision, and the question of the validity of these means of enforcement is the linchpin of its opinion. Thus, a basic understanding of these various means, or enforcement mechanisms, is essential to an understanding of the *Mahler* opinion.

PIP insurance coverage is "no fault," meaning that an insured under a PIP policy is entitled to payments when she is injured, regardless of whether she was at fault for the damages or injuries she sustained.<sup>30</sup> When an insurer makes payments for medical and other expenses under a PIP policy, it has a subrogation or reimbursement interest in those payments.<sup>31</sup> This interest entitles the insurer to be reimbursed for its payments in the event that its insured recovers the payments as part of a settlement or judgment, or, alternatively, to "step into the shoes of the insured" and actively recover its interest.<sup>32</sup> Thus, when an insurer exercises its interest to be reimbursed, it is passive, whereas when it exercises its interest to be subrogated, it is actively involved in the litigation process. Traditionally, then, as the court in *Mahler* states, the insurer has only one interest, but it has two possible mechanisms for enforcing that interest.<sup>33</sup>

However, as insurance companies have sought to adapt to the growing demands of their insureds in a more litigation-prone legal environment, and as arbitration has experienced increased popularity as an alternative to in-court adjudication, a third enforcement mechanism, contractual in nature, has become available to insurers: the interinsurer arbitration agreement. This mechanism falls somewhere between the first two in terms of the degree to which the insurer is an active litigant. When insurers are signatories to an interinsurer arbitration agreement, they agree that when one of the signatories is a PIP insurer of an injured insured and another is the liability insurer of the corresponding tortfeasor, the PIP insurer may invoke intercompany

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30. 9 GEORGE G. COUCH, ET AL., COUCH ON INSURANCE § 125:2 (3d ed. 1999) [hereinafter COUCH ON INSURANCE].

31. The *Mahler* court discusses subrogation principles in its opinion. See *Mahler*, 135 Wash. 2d at 412-13, 957 P.2d at 640-41. See also 73 AM. JUR. 2D, *Subrogation*, § 26 (1974). This Note refers to this interest generally as the insurer's PIP interest.

32. See *Mahler*, 135 Wash. 2d at 412-13, 957 P.2d at 640-41.

33. *Id.* at 412, 957 P.2d at 640.



arbitration to settle the dispute for a quick recovery of its PIP interest without resort to in-court adjudication.<sup>34</sup> Thus, when the insurer participates in intercompany arbitration, it is active to the extent of its own interest, but it does not "step into the shoes" of its insured. This device allows efficient out-of-court settlement of the insurers' interests and liabilities without prejudicing the interests of the insured. Some states even require disputed arbitration claims to be resolved through interinsurer arbitration<sup>35</sup> because of its convenience and efficiency.<sup>36</sup>

### C. Recovery of Damages in Personal Injury Lawsuits

In addition to these basic concepts, certain predicaments arise in the particular context of personal injury lawsuits that further elucidate the significance of the *Mahler* decision.<sup>37</sup> First, consider the relationship between insurer and insured in property loss cases, in which the parties experience no conflict in pursuit of their respective interests. This mutuality exists because, when loss is limited to an item of property that has an ascertainable value, the subrogation or reimbursement interest of the insurer does not surpass the value of that lost property. Therefore, the interests of insurer and insured are aligned in this context and most others. In such cases, so long as the insured's loss does not exceed the coverage limits of her property loss policy, she has no reason to litigate with the tortfeasor, because she has already been compensated. The insurer can exercise complete discretion as to whether and how it will enforce its subrogation interest, and, as a profit-seeking entity, it has every incentive to employ the most efficient methods of enforcement.

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34. See ARBITRATION FORUMS, INC., PERSONAL INJURY PROTECTION (NO-FAULT) ARBITRATION AGREEMENT, 1/96 PIP (1991) (standardized form).

35. See, e.g., COL. REV. STAT. § 10-4-717 (Supp. 1998); D.C. CODE § 35-2111 (1981); N.J. STAT. § 39.6A-11 (1990).

36. As State Farm stated in its appellate brief,

In particular, enforcement of agreements between insurers requiring arbitration of subrogation claims is supported by public policy. First, these agreements remove thousands of small claims from the court system, freeing up judicial resources for other claims. Second, inter-insurer arbitration permits insurers to resolve subrogation claims in a manner which is far less costly and time consuming than litigation. . . . Third, these arbitration agreements free first party claimants and tortfeasors from the necessity of participating in litigation of subrogation claims. It is no longer necessary for the subrogated insurer to sue the tortfeasor in the name of its insured. Instead, the subrogee arbitrates directly against the tortfeasor's insurer, without any involvement of the individuals involved in the accident.

Brief of Respondent at 36-37, *Mahler v. Szucs*, 135 Wash. 2d 398, 957 P.2d 632 (1998) (No. 65014-4).

37. The *Mahler* court recognizes some, though not all, of these issues. See *Mahler*, 135 Wash. 2d at 413-15, 957 P.2d at 641-42.

In contrast, in actions for personal injury, a plaintiff typically recovers both special damages, or out-of-pocket medical and other expenses, and general damages, or noneconomic damages for pain and suffering, in a single claim.<sup>38</sup> PIP payments, like those paid by State Farm to Mahler and Fisher, fall exclusively into the category of special damages, because they cover only the costs of the insured's medical care and wage loss.<sup>39</sup>

Furthermore, general damages have a dependent relationship to special damages; the greater the medical expenses and other special damages, the greater the amount of general damages a plaintiff will typically recover.<sup>40</sup> This dependent relationship is based on the common-sense notion that the more medical treatment necessary to rehabilitate an injured person, the more pain and suffering that person likely experienced.<sup>41</sup> As the *Mahler* court recognizes,

It is a well known fact that the dollar amount of medical expenses has a direct influence on the amount of general damages that will be awarded by a court or jury and it is for that reason that attorneys desire to prove the amount of such expenses. The amount of lost earnings also has an important impact as it tends to demonstrate the period of physical disability.<sup>42</sup>

Again, PIP insurance policies cover only special damages, specifically, medical expenses and wage loss. Therefore, if an injured person wishes to obtain compensation for pain and suffering, she must initiate a suit or threaten to initiate a suit against the tortfeasor himself, usually intending to reach funds available from the tortfeasor's liability insurance policy.

Whether the injured plaintiff recovers in court or through a settlement agreement with the liability insurer, she will have to prove her injury and the effect it has had on her before damages will be awarded. The plaintiff must provide proof of both special and general damages,

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38. "[T]he injured insured will often sue the tortfeasor to recover noneconomic damages, and include in the claim the medical expenses he or she has incurred as a result of the injury." *Mahler*, 135 Wash. 2d at 414, 957 P.2d at 641.

39. See 12 COUCH ON INSURANCE, *supra* note 30, § 171:30 (3d ed. 1999) (stating that "[G]eneral damages have never been intended as a substitute for PIP benefits.")

40. "[I]n a personal injury case, the claimed noneconomic damages typically amount to many multiples of the economic damages and are almost always disputed because they are not objectively ascertainable." *Mahler*, 135 Wash. 2d at 414, 957 P.2d at 641.

41. "Trauma or disease excite peripheral nerves, along whose pathways run the message of pain. This basic physiological concept supports the principle that the traditional claim for pain and suffering usually accompanies impact or physical injury." 23 AM. JUR. PROOF OF FACTS 2D *Pain and Suffering* § 1 (1980).

42. *Mahler*, 135 Wash. 2d at 426, 957 P.2d at 647.

although, as the *Mahler* court implied above, the two often call for the same type of proof.

In validating expenses for medical treatment after an injury, an insurance claims adjuster, or a court for that matter, considers the duration of the treatment, the extent to which it was necessary, and above all, documentation and verification of the treatment.<sup>43</sup> Likewise, when evaluating the validity of general damages, an insurer or a court weighs the intensity and duration of the injury, as well as the community reaction or public perception of how taxing the injury is.<sup>44</sup> Note that an essential element of proving the validity of both special and general damages is verification of the injury itself. The duration of an injury cannot be shown without evidence that treatment was actually provided for a given period, such as by providing copies of bills from physicians or medical care providers. To appropriately show an injury's intensity, opinions from the treating physicians as expressed in chart notes and narrative reports would be necessary. Thus, because of the dependent relationship expressed above and the necessity of verification, plaintiffs' attorneys must, in any case, document special damages resulting from an injury to recover any general damages, which typically constitute the bulk of the total damages recovery.

Having reflected on the predominance of general damages in typical personal injury recoveries, consider the motivation of an injured plaintiff who is insured under a PIP policy for seeking legal representation in the first place. Because the insured plaintiff has largely been compensated for her actual out-of-pocket expenses, or special damages, typically she seeks an attorney's assistance not to recover those special damages but to recover general damages for her associated pain and suffering. Mahler and Fisher, in securing representation, surely intended to recover general damages; they did not mean to ensure altruistically that their insurer was reimbursed for the PIP payments it had made to remedy their losses. Given the client's motivation and the attorney's obligation to serve the interests of her client,<sup>45</sup> recovery of special damages is clearly not a legitimate goal of

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43. These criteria were taken from materials provided at a Continuing Legal Education Seminar sponsored by the Washington State Trial Lawyers Association by a legal examiner in the litigation unit at Pemco Insurance Co. See Scott Tucker, *Evaluation of Personal Injury Cases - an Overview, In Evaluating a P.I. Case from the Adjuster's Point of View*, WASHINGTON STATE TRIAL LAWYERS ASSOCIATION SEMINAR MATERIALS, at 37 (Sept. 23, 1994).

44. See *id.*

45. The Washington Rules of Professional Conduct Rule 1.2(a) defines the scope of an attorney's representation of a client, providing that "[a] lawyer shall abide by a client's decisions concerning the objectives of representation . . . and shall consult with the client as to the means by which they are to be pursued." WASHINGTON RULES OF PROFESSIONAL CONDUCT Rule

the personal injury attorney. Hence, the fact that special damages are established when a personal injury attorney proves that her client has suffered general damages is incidental to the attorney's primary purpose of obtaining general damages. Consequently, unsolicited work by an attorney to recover these interests, which are no longer a concern of the insured client, clearly exceeds the scope of the attorney's representation.

#### D. Legal Precedent

##### 1. The Supreme Court of Washington: A Trilogy of Cases

Synthesizing a legal framework into the special issues that arise in personal injury lawsuits and the modern economic concerns of the insurance industry, the Washington Supreme Court has defined the rights and duties of insurers and insureds in a trilogy of cases over the past several decades.<sup>46</sup> The principles announced in these three cases and in cases handed down by the court of appeals contradict the holding of *Mahler*.

In *Metropolitan Life Insurance Co. v. Ritz*, the court laid down a duty on the part of an insured not to prejudice an insurer's reimbursement or subrogation interest.<sup>47</sup> There, the plaintiff insurance company had paid the defendant insured for medical expenses arising out of an automobile accident pursuant to a group policy that covered "medical expenses."<sup>48</sup> The insured, to receive this compensation, signed a reimbursement agreement, promising to reimburse Metropolitan Life "to the extent of any recovery of said expenses as the result of legal action or settlement . . ."<sup>49</sup> However, the insured then negotiated with the tortfeasor without notifying Metropolitan Life, signing a "Release in Full of All Claims," in which the insured released the tortfeasor from all claims or potential claims arising out of the accident.<sup>50</sup> The trial court found, however, that by signing a

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1.2(a) (1990). Considering that a client who is insured under a PIP policy is already compensated for medical expenses, it is unlikely that recovering these medical expenses from the tortfeasor would be one of the "objectives of representation" of such a client.

46. See *Leader Nat'l Ins. Co. v. Torres*, 113 Wash. 2d 366, 779 P.2d 722 (1989); *Thiringer v. American Motors Ins. Co.*, 91 Wash. 2d 215, 588 P.2d 191 (1978); *Metropolitan Life Ins. Co. v. Ritz*, 70 Wash. 2d 317, 422 P.2d 780 (1967).

47. See *Metropolitan Life*, 70 Wash. 2d 317, 422 P.2d 780.

48. *Id.* at 318, 422 P.2d at 781.

49. *Id.* at 318-19, 422 P.2d at 781.

50. The agreement stated:

For and in consideration of the payment to me/us at this time of the sum of Seven thousand and no/100 Dollars (\$7000.00), the receipt of which is hereby acknowledged, I/we, being of lawful age, do hereby release, acquit and forever discharge [the

complete release without the insurer's consent, the insured had "extinguished [the insurer's] right of subrogation,"<sup>51</sup> unduly prejudicing the insurer's interest and depriving it of its rights.<sup>52</sup> Thus, the court stressed the importance of the need for the insurer's consent whenever an insured enters into a settlement agreement involving the insurer's PIP interest.<sup>53</sup>

In light of this prejudice, the court held that a PIP insurer can recover its interest directly from the insured when the insured, as part of such a settlement agreement with the tortfeasor's liability insurer, signs a release of claims for medical expenses without the knowledge of the PIP insurer.<sup>54</sup> Thus, in *Metropolitan Life*, the court considered the insurer's knowledge and consent to a settlement agreement that might adversely affect its ability to recover its interest to be of paramount concern in its decision.

Significantly, the court in *Metropolitan Life* also rejected the argument made by the defendant insureds that they did not intend to settle "medical expenses," and that the settlement agreement executed with the tortfeasor represented compensation only for general damages and wage loss.<sup>55</sup> Thus, *Metropolitan Life* reflects the necessity for characterization of settlement recoveries to the extent that they compensate an insured for either general or special damages. While the court does not expressly state this necessity, this case demonstrates the prejudice to the parties' interests that can otherwise result from ambiguity over whether a settlement denotes compensation for general damages or medical expenses. Furthermore, despite any specific espousal by the court for characterization of damages recovered pursuant to a settlement agreement, this solution seems the obvious remedy to the undesirable effects of settlement ambiguity apparent in *Metropolitan Life*.

Next, in *Thiringer v. American Motors Ins. Co.*, the court established that an insured must be fully compensated before an insurer can recover its PIP payments or, as in the *Thiringer* case itself, before an

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tortfeasor] of and from any and all actions, causes of action, claims, demands, damages, costs, loss of services, expenses and compensation on account of, or in any way growing out of, any and all known and unknown personal injuries and property damage resulting or to result from accident that occurred on or about the 27th day of November, 1960, at or near U.S. Highway #30, near Cascade Locks, Oregon.

*Id.* at 319, 422 P.2d at 781-82.

51. *Id.* at 320, 422 P.2d at 782.

52. *Id.*

53. The court notes that "[t]his settlement was arranged without the assistance or advice of the plaintiff insurance company." *Id.* at 319, 422 P.2d at 781-82.

54. *Id.* at 321, 422 P.2d at 783.

55. *Id.*

insurer can refuse to make PIP payments subsequent to an insufficiently small settlement.<sup>56</sup> According to the court,

The general rule is that, while an insurer is entitled to be reimbursed to the extent that its insured recovers payment for the same loss from a tort-feasor responsible for the damage, it can recover only the excess remaining after the insured is fully compensated for his loss by the wrongdoer.<sup>57</sup>

By this statement, the court invoked the so-called "make whole" doctrine,<sup>58</sup> which serves to protect insureds by ensuring that they are fully compensated by a settlement. While this rule appears to be a rational approach to fair allocation of settlement recoveries, without any guidance to its proper application it evokes a barrage of uncertainties.<sup>59</sup> Chiefly, the rule fails to prescribe when an insured is fully compensated and who must bear the burden of proving this fact. Again, requiring an insured to characterize the recoveries in a settlement resolves these uncertainties most easily. As a party to the agreement, the insured plaintiff knows the basis for the recovery and can more easily identify that basis than an insurer can by speculation. Hence, *Thiringer* reinforces the characterization principle evident in the court's decision in *Metropolitan Life*—it implicitly requires characterization of recovery in a settlement between an injured person covered by a PIP policy and a liability insurer. When an injured person settles with a liability insurer for an amount partially for special damages and partially for general damages, that injured person must implicitly consent to the recovery being allocated as the settlement agreement characterizes it.

*Thiringer* also demonstrates that plaintiffs' attorneys can feasibly document special damages without claiming them as part of a settlement. In *Thiringer*, the plaintiff's attorney documented special damages in order to recover general damages from the tortfeasor and his insurer to the extent that either the tortfeasor's assets or his insurance coverage could pay for them. In turn, the PIP insurer had to pay PIP benefits, even though there was no chance that it would ever be reimbursed, because the insured's medical expenses exceeded both the tortfeasor's assets and his insurance coverage.<sup>60</sup> Therefore, the docu-

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56. *Thiringer v. American Motors Ins. Co.*, 91 Wash. 2d 215, 219, 588 P.2d 191, 193 (1978).

57. *Id.*

58. For a discussion of the "make whole" doctrine, see Roger M. Baron, *Subrogation: A Pandora's Box Awaiting Closure*, 41 S.D. L. Rev. 237, 249-51 (1996).

59. See Baron, *supra* note 58, at 251.

60. *Thiringer*, 91 Wash. 2d at 217, 588 P.2d at 192. The insured accepted a \$15,000 settlement, which was the limit of the tortfeasor's liability insurance policy, and the tortfeasor had

mentation of special damages was merely an evidentiary necessity in obtaining general damages, and the plaintiff's attorney received no portion of special damages for that documentation. Instead, he was compensated exclusively by a percentage of the general damages agreed to in a contingent fee agreement with his client, the insured plaintiff.

Finally, in the most recent of the Washington Supreme Court's trilogy of decisions, *Leader National Insurance Co. v. Torres*, the court protected the interests of PIP insurers from tortfeasors and their liability insurers directly.<sup>61</sup> There, an insured received medical expense payments under a PIP policy with his insurer, Leader National, settled with the tortfeasors, and signed an agreement that was approved by the trial court, which released the tortfeasors, their insurer, and their attorney from "any and all claims."<sup>62</sup> The Washington Supreme Court held that a PIP insurer has a right of action against a liability insurer when, aware that the PIP insurer has a reimbursement interest, the liability insurer settles with an insured, and requires the insured to sign a general release without the PIP insurer's knowledge.<sup>63</sup> Thus, this decision effectively established a liability insurer's duty to ascertain that a PIP insured is notified of and consents to any settlement agreement with one of its insureds that affects its reimbursement interest, again emphasizing the necessity of the PIP insurer's consent to any settlement that will dispose of or prejudice its rights.<sup>64</sup> Therefore, whereas *Thiringer* requires the insured to preserve the PIP insurer's reimbursement interest, *Leader National* requires the same of a liability insurer.

Each of these related decisions, while addressing issues slightly different from the one presented in *Mahler*, hinges on the insurer's consent and the degree to which a settlement would infringe on its rights to pursue its reimbursement or subrogation interest in whatever fashion it deems most beneficial. They thereby uphold the free choice principle discussed in Section II.

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no other reachable assets. *Id.* Because the tortfeasor's assets had been totally extinguished, the insurer, the court reasoned, could not have been prejudiced by the settlement agreement, and therefore it could not deny recovery on the policy. *Id.* at 218, 588 P.2d at 193.

61. *Leader Nat'l*, 113 Wash. 2d at 373-74, 779 P.2d at 726.

62. *Id.* at 368, 779 P.2d at 723.

63. *Id.* at 373-74, 779 P.2d at 726. The Washington Supreme Court held that "a release between an insured and a tortfeasor does not extinguish the insurer's subrogation rights if (1) the tortfeasor knows of the insurer's payment and right of subrogation, (2) the insurer does not consent to the settlement, and (3) the settlement does not exhaust the tortfeasor's assets." *Id.*

64. See *id.* (holding that when the PIP insurer "does not consent to the settlement" reached by the tortfeasor and the liability insurer, it can recover its subrogation interest directly from the liability insurer).

## 2. The Washington Court of Appeals: Overlooked Decisions

Applying the same line of reasoning, Division III of the Washington Court of Appeals has heard at least two cases that are factually almost identical to the cases consolidated in *Mahler*.<sup>65</sup> In *Pena v. Thorington*, the court denied a claim for attorney's fees when the insurer had actively pursued recovery of its subrogated interest with the liability insurer.<sup>66</sup> The court held that "[i]f the insurer decides to pursue its subrogation claim on its own, it should have the right to do so."<sup>67</sup> In *Pena*, the court preserved the insurer's right to arrange for payment of its subrogation interest directly from the defendant's insurer. Like the court in *Mahler*, the *Pena* court focused on the benefit to the insured in determining whether or not attorney's fees should be shared. It made this determination based on "[w]hether the services of [the plaintiff's] attorney were necessary under the circumstances . . . ."<sup>68</sup> Hence, because another means of collecting the insurer's subrogation interest was available, the court refused to award attorney's fees.<sup>69</sup>

Taking the *Pena* court's rationale and extending it to the facts of *Mahler*, the *Mahler* court should logically have denied attorney's fees. Like the insurer in *Pena*, State Farm preferred to pursue its PIP interest via a completely viable, although different, means than its insured—intercompany arbitration. While State Farm had not actually litigated its PIP interest, as the plaintiff insurer in *Pena* did, it unambiguously expressed its intention to do so in its letter to Mahler's attorney.<sup>70</sup> In Fisher's case, State Farm was given insufficient notice of Fisher's independent representation to make a decision.<sup>71</sup>

Finally, in *Richter, Wimberly & Ericson v. Honore*, the court denied the recovery of attorney's fees, enforcing policy language which read, almost identical to that of the policy in *Mahler*, "This provision shall not apply as to such amounts recovered or recoverable by the Company from another insurer pursuant to the Inter-company Arbitration Agreements . . . ."<sup>72</sup>

Again, in this decision, the court honored the right of the insurer to pursue its interests in the manner of its choice, giving full force to a

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65. See, e.g., *Richter, Wimberly & Ericson v. Honore*, 29 Wash. App. 507, 628 P.2d 1311 (1980); *Pena v. Thorington*, 23 Wash. App. 277, 595 P.2d 61 (1979).

66. 23 Wash. App. at 282, 595 P.2d at 64.

67. *Id.*

68. *Id.* at 281-82, 595 P.2d at 64.

69. *Id.*

70. See *Mahler v. Szucs*, 135 Wash. 2d 398, 406, 957 P.2d 632, 637 (1998).

71. See *id.* at 408, 957 P.2d at 638.

72. 29 Wash. App. at 508, 638 P.2d at 1312 n.1.



nearly identical interinsurer arbitration clause. Along the same lines of reasoning, other states' courts have also held that an insured cannot recover a share of legal expenses from the insurer when it settles the insurer's subrogation claim, unless it gives prior notice to and obtains consent from the insurer.<sup>73</sup>

Admittedly, the *Mahler* court was not bound by either *Pena* or *Richter*, since both were handed down by lower courts. However, the *Mahler* court fails even to mention them in its analysis, much less to explain why it holds that their analyses are incorrect or why it has chosen to turn the public policy of several decades on its head.

### E. Possible Policies Behind the *Mahler* Court's Decision

Recall that in *Mahler*, the court held that when a plaintiff has received payments from her PIP insurer and subsequently hires an independent attorney to litigate damages, the insurer is required to pay reasonable attorney's fees if the insured's attorney recovers its PIP interest from the liability insurer. The court imposes this duty on the insurer even when the insured's attorney collects the insurer's interest against its express will.<sup>74</sup> As the following discussion will reveal, the *Mahler* court fails in its attempt to justify its holding with a strict reading of the policy language.

However, the reasons that may have motivated the court in reaching its decision are not inconceivable. An insurance policy is a contract, and the courts have consistently held that an insurance policy should be interpreted as such.<sup>75</sup> On the other hand, because of the unequal bargaining power between insurers and their insureds, the doctrine of *contra proferentem*, or interpreting contract ambiguity

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73. See *First of Georgia Ins. Co. v. Horne*, 170 S.E.2d 452 (Ga. Ct. App. 1969) (a mere volunteer cannot recover); *Miner v. Farmers Ins. Co.*, 778 P.2d 778, 780 (Idaho 1989) ("notice to the insurer that the insured is pursuing an action or settlement that includes the subrogated interest is necessary before the insured may charge the insurer attorney fees for the collection of the subrogated interest"); *Illinois Auto Ins. Exch. v. Braun*, 124 A. 691, 694 (Pa. 1924) (no attorney's fees where plaintiffs "settled the case without the knowledge or acquiescence of" the insurer); *State Farm Mut. Auto Ins. Co. v. Geline*, 179 N.W.2d 815 (Wis. 1970) (notice to insurer not only that a claim is being asserted or action has been commenced, but also that a reasonable fee for services rendered in collecting the subrogated interest will be requested, is required before seeking or securing an attorney's fee from the subrogee insurer).

74. See *Mahler*, 135 Wash. 2d at 436, 957 P.2d at 652.

75. See, e.g., *Findlay v. United Pac. Ins. Co.*, 129 Wash. 2d 368, 378, 917 P.2d 116, 121 (1996); *McMahan & Baker, Inc. v. Continental Cas. Co.*, 68 Wash. App. 573, 578, 843 P.2d 1133, 1136 (1993). See also KEETON, *INSURANCE LAW*, *supra* note 1, § 3.10(a) at 153. "In general, the attitude of courts toward subrogation is perhaps best described as one of allowing complete freedom of contract and trying to determine and enforce the expressed intention of the contracting parties." *Id.*

against the drafter,<sup>76</sup> is traditionally adhered to even more closely when interpreting insurance policies.<sup>77</sup> Yet, the doctrine is typically used against an insurer in cases where coverage or a duty to defend has been denied by its insurer, not where the insurer merely insists on pursuing its own interest according to the policy language as in *Mahler*. Thus, *contra proferentem* is generally justified where the insured's interests are affected by the discretion of the insurer under the policy.<sup>78</sup>

In *Mahler*, State Farm provided coverage in the form of PIP payments. Thus, in exercising its discretion to pursue its interests by arbitration, State Farm did not affect the interests of its insureds, and the policies for invoking *contra proferentem* were not present. Besides State Farm, only *Mahler's* and *Fisher's* attorneys had any real interest in how this clause was interpreted. Since neither *Mahler's* nor *Fisher's* attorneys were a party to this policy, they should not be able to offer its meaning against State Farm, *contra proferentem*.

Instead, the arbitration clause in the policy should be interpreted according to ordinary contract principles regarding the intents of the contracting parties. The Washington Supreme Court has repeatedly held that contract language should not be given a meaning that is unreasonable.<sup>79</sup> As discussed below, the court's interpretation of the policy is unreasonable, given the very purpose of subscribing to an interinsurer arbitration agreement.

The *Mahler* court may also have been motivated by a desire to increase access to the judicial system for plaintiffs. The court's holding does provide a greater incentive for plaintiffs' attorneys to provide representation to injured plaintiffs, because it enables them to collect a portion, typically one third, of not only general damages but also special damages for doing essentially the same amount of work. However, whatever social benefits might come from enabling plaintiffs' attorneys to kill two birds with one stone in this manner is more than outweighed by the burden to all policyholders of higher premiums.

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76. The doctrine of *contra proferentem* is reflected in the Restatement (Second) of Contracts § 206, which provides that "in choosing among the reasonable meanings of a promise or agreement or a term thereof, that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds." RESTATEMENT (SECOND) OF CONTRACTS § 206 (1932).

77. See SPENCER L. KIMBALL, CASES AND MATERIALS ON INSURANCE LAW 7 (1992).

78. See *id.*

79. See *Lynott v. National Union Fire Ins. Co.*, 123 Wash. 2d 678, 689-90, 871 P.2d 146, 152 (1994). "An interpretation of an insurance clause must be reasonable and take into account the purpose of the insurance at issue." *Id.*

### III. THE MAHLER COURT'S ANALYSIS OF THE POLICY LANGUAGE

#### A. *Two Independent Contracts*

Before discussing the court's analysis of the policy language, it will help to recall that there are two documents involved in this case: the policy held by the plaintiffs and the interinsurer arbitration agreement. Both of these are contracts, the former between the plaintiffs and State Farm and the latter between State Farm and other insurers that are signatories to the interinsurer arbitration agreement. While the interinsurer arbitration agreement is referred to in the policies held by the plaintiffs, it is a completely separate and independent agreement between different parties.

The *Mahler* court begins its analysis by appealing to the principles of subrogation, "an equitable doctrine the essential purpose of which is to provide for a proper allocation of payment responsibility. [Subrogation] seeks to impose ultimate responsibility for a wrong or loss on the party who, in equity and good conscience, ought to bear it."<sup>80</sup> However, the court's resolution of the case contradicts this goal, forcing the insurer of the nonliable party to pay for legal expenses incurred as a result of the tortfeasor's negligence and misconduct.

The court justifies its decision by scrutinizing the policy language involved in these actions as well as the language of the interinsurer arbitration agreement.<sup>81</sup> Starting with the first paragraph of

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80. *Mahler v. Szucs*, 135 Wash. 2d 398, 411, 957 P.2d 632, 640 (1998) (citing RONALD C. HORN, SUBROGATION IN INSURANCE THEORY AND PRACTICE 3 (1964)).

81. The hypothetical factual scenario provided in Part I.B., *supra*, includes the exclusion clause. However, a greater portion of the policy, discussed by the court, in a section under the heading, "Our Right to Recover Our Payments," reads as follows:

- a. Medical payments, death, dismemberment and loss of sight and total disability coverage payments are not recoverable by us.
- b. Under personal injury protection and underinsured motor vehicle coverages, we are subrogated to the extent of our payments to the proceeds of any settlement the injured person recovers from any party liable for the bodily injury or property damage.

If the person to or for whom we have made payment has not recovered our payment from the party at fault, he or she shall:

- (1) keep these rights in trust for us and do nothing to impair them;
- (2) execute any legal papers we need; and
- (3) when we ask, take legal action through our representative to recover our payments.

We are to be repaid our payments, costs, and fees of collection out of any recovery.

- c. Under all other coverages the right of recovery of any party we pay passes to us. Such party shall:
  - (1) not hurt our rights to recover; and
  - (2) help us get our money back.

Paragraph b<sup>82</sup> of the policy, the court concludes that because this paragraph only applies to settlements recovered by an insured, the language indicating that State Farm was "subrogated" to the extent of such settlements clearly contemplates the reservation of a reimbursement interest rather than a subrogation interest.<sup>83</sup> Thus, this paragraph implies, by referring to "settlements," that State Farm did not intend to "step into the shoes" of its insureds and litigate in court. Therefore, the first paragraph of Paragraph b<sup>84</sup> contemplates the more passive role to be played by the insurer, which, as discussed above, indicates the reservation of a reimbursement interest.

On the other hand, the second paragraph of Paragraph b and Paragraph c,<sup>85</sup> referring to State Farm's ability to "take legal action through [its] representative to recover [its] payments," creates a traditional subrogation interest whereby State Farm reserves the right to "step into the shoes" of its insureds by litigating their rights in court to recover its own PIP payment interest.<sup>86</sup>

Given this sensible interpretation of the interests reserved by the respective clauses of the policy, the court wrongly concludes that the exception in the second paragraph of Paragraph d<sup>87</sup> of the policy, indicating that State Farm need not share the cost of attorney's fees with its insureds whenever its PIP interest is "recovered or recoverable by [State Farm] under any interinsurer arbitration agreement," is inapplicable.<sup>88</sup> The court reaches this conclusion by infusing into the meaning of the PIP policy a strained reading of the applicable rules under the interinsurer arbitration agreement. The Personal Injury Protection Arbitration Agreement Rules and Regulations provide that the agreement "shall not be construed to create any causes of action or liabilities not existing in law or equity."<sup>89</sup> In light of this restriction, the court reasons that because State Farm technically only had a cause

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- d. If the insured recovers from the party at fault and we share in the recovery, we will pay our share of the legal expenses. Our share is that percent of the legal expenses that the amount we recover bears to the total recovery. This does not apply to any amounts recovered or recoverable by us from any other insurer under any inter-insurer arbitration agreements.

Our right to recover applies only after the insured has been fully compensated for the bodily injury, property damage or loss.

*Mahler*, 135 Wash. 2d at 418-19, 957 P.2d at 643 (quoting the State Farm policy language).

82. *See id.*

83. *Id.* at 419-20, 957 P.2d at 644.

84. *See note 81 supra.*

85. *See id.*

86. *Mahler*, 135 Wash. 2d at 420-21, 957 P.2d at 644.

87. *See note 81 supra.*

88. *Mahler*, 135 Wash. 2d at 423, 957 P.2d at 646.

89. *Id.*

of action against the respective tortfeasors in these cases, Dr. Szuchs and Aldi Tire, Inc., and not their insurers, its interests under the PIP policies were not "recoverable," because to allow State Farm to arbitrate these claims with the liability insurer would violate this rule.<sup>90</sup> This reasoning sharply contradicts both traditional principles of contract law and Washington case law that adopts such principles.

One of the most basic principles of contract interpretation under the prevailing conception of subjective intent is that the contract terms, in any case in which both parties agree on one subjective meaning, are to be given that shared subjective meaning.<sup>91</sup> The court has held that:

[D]etermination of the intent of the contracting parties is to be accomplished by viewing the contract as a whole, the subject matter and objective of the contract, all the circumstances surrounding the making of the contract, the subsequent acts and conduct of the parties to the contract, and the reasonableness of respective interpretations advocated by the parties.<sup>92</sup>

The court's rationale for determining that the PIP interests here are not "recoverable" violates this principle on two fronts: in its unstated interpretation of the meaning to be given to the arbitration rules and in its application of that meaning to the terms of the PIP policy.

First, while the arbitration rules exclude any causes of action or liabilities an insurer would not have at law,<sup>93</sup> it seems unreasonable to assume that the signatories to such an arbitration agreement would intend that this clause would be applicable in this respect. If the signatories had intended for the agreement to have this meaning, the agreement would have no force or purpose whatsoever in the resolution of PIP payment interest disputes amongst insurers. State Farm and the other insurer-signatories would never have signed on to such a meaningless agreement in the first place! A PIP insurer's legal cause of action is always limited to a claim against the tortfeasor, but the insurers that are signatories to the interinsurer arbitration agreement signed the agreement with the reality in mind that, for all intents and purposes, insurance companies do indeed have claims against one

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90. *See id.*

91. *See generally* E. ALLAN FARNSWORTH, *CONTRACTS* § 7.9 (1990). "The touchstone of contract interpretation is the parties' intent." *Tanner Elec. Co-op v. Puget Sound Power & Light Co.*, 128 Wash. 2d 656, 674, 911 P.2d 1301, 1310 (1996).

92. *Berg v. Hudesman*, 115 Wash. 2d 657, 667, 801 P.2d 222, 228 (1990).

93. *See Mahler*, 135 Wash. 2d at 423, 957 P.2d at 646.

another. They are activated contractually by their insureds rather than by tort law itself, but they are always activated at some point.

A more reasonable interpretation of this provision of the arbitration rules is that the contracting insurers intended that the arbitration agreement would not be construed to create any causes of action or liabilities not existing in law or equity other than those that would exist between the insurers and/or their corresponding insureds with whom they are in privity of contract. In other words, as Jeffrey Stempel writes, the lack of a cause of action at law between a liability insurer and a PIP insurer is "no stumbling block to the use of either arbitration or appraisal in first party claims, since an obvious contract exists between insurer and policyholder . . . ."<sup>94</sup> Thus, when the very purpose of the interinsurer arbitration agreement is considered, the *Mahler* court's construction of the rules of the agreement is unreasonable.

Second, the court wrongly imputes this strained interpretation of the arbitration agreement rules to the intents of State Farm and its insureds, the parties to the insurance policy. As noted earlier, an insurance policy is a contract and should be construed as such.<sup>95</sup> Again, the court should defer to any subjective intent that both insurer and insured attached to the meaning of the policy. As discussed above, assuming only that the insurer intended that the arbitration agreement it signed would serve some purpose, the court should conclude that it intended that its PIP interest was "recoverable" against a liability insurer, even though it was not technically recoverable in a court of law without the tortfeasor first contractually activating the duties his insurer owed him.

Likewise, it is unlikely that an insured, like Ms. Mahler or Ms. Fisher, would be aware of this legal technicality, or that an insured would attach the meaning that such an interest is not "recoverable" under the policy terms because State Farm would have no cause of action at law against another insurer. Therefore, the court's imposition of this strained interpretation on the intents of the parties to the insurance policy is also unreasonable.

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94. JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS § 31.8, 764 (1996); see also KEETON, INSURANCE LAW, *supra* note 1, § 3.10(a) at 157 (indicating that some "courts have treated the insurer as the real party in interest and, indeed, as *the* real party in interest when it has paid the loss in full," and citing *Ellis Canning Co. v. International Harvester Co.*, 225 P.2d 658 (Kan. 1953), and *Shambley v. Jobe-Blackley Plumbing & Heating Co.*, 142 S.E.2d 18 (N.C. 1965), where insurers were made party plaintiffs as the real parties in interest in tort actions on behalf of their insureds).

95. See *Findlay v. United Pac. Ins. Co.*, 129 Wash. 2d 368, 378, 917 P.2d 116, 121 (1996).

Having delivered its argument on the supposed inapplicability of the exception for payment of attorney's fees in the policy, the court, "assuming *arguendo* State Farm does have a claim against the tort-feasor's insurers that makes its PIP payments 'recoverable,'" wrongly determines that State Farm had nothing to recover in any case.<sup>96</sup> It reaches this conclusion, again, by disregarding applicable contract principles and by ignoring the fact that the arbitration process is completely separate from and independent of any judicial proceeding.

The court begins by reiterating that because Mahler and Fisher decided to actively litigate their claims against the liability insurers, "State Farm had only a right of reimbursement from its insureds from the proceeds of the settlements" and "State Farm had to await the outcome of the settlement process before attempting any recovery from the tortfeasors' insurers."<sup>97</sup> Reciting the rule in *Thiringer* that precludes a PIP insurer from recovering any of its payments until its insured is fully compensated, the court concludes that "there was nothing left for State Farm to recover," since Mahler and Fisher had already recovered the PIP interests.<sup>98</sup> This reasoning ignores both State Farm's swift instruction to its insureds that it intended to pursue its interests on its own and the fact that the arbitration process is independent of claims pending in court.<sup>99</sup> In effect, the court allows the insureds to ignore any express wishes of the insurer regarding the means by which it will pursue its own interest.

Again, as soon as State Farm learned that Mahler had hired her own attorney, it gave express notice that it intended to recover its PIP payments by means of the interinsurer arbitration agreement, and it advised her attorney that he should do nothing to recover that interest.<sup>100</sup> By ignoring this instruction, Mahler's attorney was not motivated by the best interests of his client, for Ms. Mahler had already been fully compensated for her medical expenses directly from State Farm. Rather, he was motivated by the fact that if he recovered it, he would be able to take one third of that additional interest for himself, but without having any additional work. The court should not reward Mahler's attorney for flatly disregarding that instruction for no one's benefit but his own.

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96. *Mahler v. Szucs*, 135 Wash. 2d 398, 423-24, 957 P.2d 632, 646 (1998).

97. *Id.* at 424, 957 P.2d at 646.

98. *Id.*

99. See *supra* Section III.A for a discussion of the terms of the interinsurer arbitration agreement, which, contrary to the court's underlying assumptions here, indicate that the arbitration process is independent in that it does not rely on any in-court adjudicatory proceeding.

100. *Mahler*, 135 Wash. 2d at 406, 957 P.2d at 637.

Similarly, in Fisher's case, State Farm had not been notified that its insured intended to litigate special damages until the brink of settlement, but it gave a similar notice as soon as it was notified.<sup>101</sup> Fisher's attorney should have given notice as soon as he began representing Ms. Fisher so that State Farm could decide whether or not to invoke interinsurer arbitration. Again, Ms. Fisher had already been compensated for her medical expenses directly from State Farm, and she had sought counsel only in hopes of obtaining general damages. Therefore, her attorney, like Ms. Mahler's, was motivated not by his client's interests but by his own.

Furthermore, the arbitration proceeding is independent of any judicial proceeding, as is reflected in the rules of the arbitration agreement that the *Mahler* court relies on so extensively, which provide that "[a] finding as to the amount of damages at issue shall be based upon the facts presented to the arbitrators."<sup>102</sup> Again, although the existence of rights and duties in tort law between an insured and a tortfeasor activates a contractual relationship between liability and PIP insurers, as the above clause plainly indicates, that relationship is not governed by what occurs in court between the insured and the tortfeasor. Thus, the arbitration agreement is independent of any dispute over injuries between the insured and the liability insurer in court, and it will not affect the insured's right under *Thiringer* to be fully compensated for those injuries by adjudicating her claim in court.

### *B. One Body of Evidence Establishing Two Types of Damages*

Next, the *Mahler* court addresses various public policy arguments. First, it accurately states State Farm's position that "injured plaintiffs [should be required to] refrain from seeking recovery from defendants for PIP benefit payments simply because State Farm might elect to recover those payments on its own."<sup>103</sup> However, it incorrectly concludes that such a rule would result in "reduced general damage awards by juries," asserting that "[i]njured plaintiffs should be able to introduce all relevant evidence to support their general damages claim."<sup>104</sup>

The court misinterprets the position opted for by State Farm by erroneously assuming that insurers mean to preclude plaintiffs' attorneys from introducing any relevant evidence whatsoever to prove the

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101. See *id.* at 408-09, 957 P.2d at 638-39. See also *supra* note 21.

102. ARBITRATION FORUMS, INC., PERSONAL INJURY PROTECTION (NO-FAULT) ARBITRATION AGREEMENT RULES AND REGULATIONS, 1/96 PIP (1991) (standardized form).

103. *Mahler*, 135 Wash. 2d at 426, 957 P.2d at 647.

104. *Id.*



general damages incurred by their clients. Indeed, plaintiffs will usually need to introduce documentary evidence of special damages in order to prove general damages. However, as discussed earlier, the fact that such proof substantiates special damages is incidental to the attorney's purpose of obtaining a general damage award for his client. After all, in most cases the client who is insured under a PIP policy does not seek representation to recover special damages, because those have already been covered by the PIP insurer.

Plaintiffs' attorneys should, rather, be required to treat proof establishing special damages that they incidentally provide as they would any other evidence establishing general damages, and they should be precluded from recovering such an incidentally proven claim on the insurer's behalf. Or, if an attorney does use such evidence as proof of special damages and then in fact collects the special damages proven, she should be required to turn over those special damages, insofar as they amount to PIP payments, to the PIP insurer without deducting any fees, assuming, of course, that the PIP insurer did not authorize the attorney to represent it. This rule would discourage abuse of PIP insurers' financial resources by plaintiffs' attorneys and preserve the principle of free choice.

### *C. A Forced Attorney/Client Relationship and Misapplication of the Common Fund Doctrine*

The *Mahler* court further rejects the argument by State Farm that it should not be required to pay part of Mahler's and Fisher's attorney's fees, because it had no consensual attorney/client relationship with either Mahler's or Fisher's attorneys.<sup>105</sup> It bases this conclusion on the common fund doctrine,<sup>106</sup> ultimately demanding that "if State Farm wishes to receive the benefit of the funds Mahler and Fisher recovered, it must share the expenses of recovering those funds."<sup>107</sup>

An examination of the case law reveals that the common fund doctrine is clearly not applicable to this case, and the court demonstrates its misapplication by its characterization of State Farm as "the benefited party," whose consent is not required under the doctrine.<sup>108</sup>

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105. *Id.* at 427, 957 P.2d at 648.

106. The common fund doctrine is an equitable doctrine under which the court awards attorney's fees to litigants who "preserve or create a common fund for the benefit of others as well as themselves." *Covell v. City of Seattle*, 127 Wash. 2d 874, 891, 905 P.2d 324, 333 (1995).

107. *Mahler*, 135 Wash. 2d at 427, 957 P.2d at 648.

108. *Id.*

The court cites *Covell v. City of Seattle* as supportive of its proposition that this is a common fund case.<sup>109</sup> *Covell*, however, was a class-action case where a group of taxpayers opposed a city ordinance imposing a residential street utility charge as unconstitutional.<sup>110</sup> In *Covell*, the court awarded attorney's fees to the prevailing class, because the plaintiffs had "created a specific monetary fund and conferred a substantial benefit on an ascertainable class."<sup>111</sup> Similarly, all of the cases cited by the court in *Covell* in its decision to invoke the common fund doctrine involve class-action plaintiffs.<sup>112</sup> In *Covell*, the court observes that "[w]hen attorney fees are available to prevailing class action plaintiffs, plaintiffs will have less difficulty obtaining counsel and greater access to the judicial system. Little good comes from a system where justice is available only to those who can afford its price."<sup>113</sup>

These policy considerations, which the *Covell* court deemed merit application of the common fund doctrine, are simply not present in *Mahler*. Because *Mahler* involves subrogation and its vicarious relationships, it is unclear whether the court meant to analogize the plaintiffs in *Covell* to State Farm or to the plaintiffs, Mahler and Fisher.

In any case, considering the parties and the resources available to them, neither of these alternatives is a fair comparison that justifies invoking the doctrine. Mahler and Fisher each had access to the judicial system, as they had each retained attorneys who had acquired significant general damages awards to compensate them for their losses. Likewise, State Farm, an insurance company with innumerable attorneys at its disposal, unquestionably had access to the judicial system. More importantly, however, State Farm did not desire to have access to the judicial system, and had subscribed to an arbitration process that would enable it to reduce its dependency on the judicial system for resolution of disputes with other insurers. As noted earlier, the inevitable increase in the price of premiums surely outweighs any greater access to the judicial system that this award of attorney's fees might inspire.

With such less expensive options available, the nonconsensual relationship that was imposed on State Farm in no way benefited it.

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109. *Id.* at 427-28, 957 P.2d at 647.

110. 127 Wash. 2d 874, 905 P.2d 324 (1995).

111. *Id.* at 892, 905 P.2d at 333.

112. *Id.* at 891-92, 905 P.2d at 333 (citing *Bowles v. Department of Retirement Systems*, 121 Wash. 2d 52, 70-71, 847 P.2d 440, 449-50 (1993); *Public Utility Dist. 1 v. Kottsick*, 86 Wash. 2d 388, 390, 545 P.2d 1, 3 (1976)).

113. *Id.* (citing *Bowles*, 121 Wash. 2d at 70-71, 847 P.2d at 449-50).

Indeed, the benefit the court supposes State Farm received actually caused it to lose one third of its PIP interest. Thus, the court is incorrect in concluding that a consensual attorney/client relationship is not required between State Farm and Mahler's and Fisher's attorneys.

The court itself illustrates the intuitive fallacy of its argument when it counters State Farm's assertion that the attorneys did not truly recover medical expenses, declaring that "State Farm has no standing to complain about fee agreements it is not a party to."<sup>114</sup> Having established that State Farm is not a "benefited party" as the court posits, since imposition of this relationship has cost it one third of its PIP interest, State Farm is nevertheless suppressed from even contesting the terms of the agreement to which it is fettered. With this result's inherent unfairness, the court does not attain the lofty goals of the equitable doctrine of subrogation it initially set out to reach.

Finally, the court also rejects State Farm's contention that this forced relationship can create a conflict of interests if the attorney, acting principally out of his own and his client's interests to maximize the total settlement amount, were to compromise the insurer's interest in maximizing the recovery of its PIP interest.<sup>115</sup> Indeed, this argument is sound and meritorious, and the court dismisses it not on the basis of any flaw, but rather as a second corollary of its misapplication of the common fund doctrine to this case.<sup>116</sup> However, its mistaken application of the doctrine leads the court to a conclusion blatantly at odds with the holdings in *Metropolitan Life*, *Thiringer*, and *Leader National*, which, as discussed earlier, imply that whenever an insured enters a settlement agreement, special damages must be separated from general damages so as not to prejudice the insurer's interests.<sup>117</sup>

In opposition to this idea, the *Mahler* court, holding steady to its position that there is no conflict of interests here, states that

[i]t makes no difference how State Farm's insureds may choose to segregate and label their recovery from the tortfeasor into general damages and special damages (something a typical plaintiff has no interest in doing anyway)—the amount State Farm is entitled to by means of subrogation is based solely on what benefits it paid out.<sup>118</sup>

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114. *Mahler*, 135 Wash. 2d at 429, 957 P.2d at 649.

115. *Id.* at 427-28, 957 P.2d at 648.

116. *See id.*

117. *See supra* Section II.D.1 for a discussion of how these three cases implicitly call for separation of special damages from general damages.

118. *Mahler*, 135 Wash. 2d at 428, 957 P.2d at 648.

Perhaps Ms. Mahler and Ms. Fisher have no interest in segregating these amounts, but State Farm surely does. Otherwise, how can an insurer or a court know whether or not the insurer's reimbursement interest has been prejudiced by a settlement agreement? Without some documentation of the extent to which an insured's settlement recovery represents either general or special damages, an insurer can never effectively seek to protect its reimbursement interest from prejudice imposed by the insured, as *Metropolitan Life* entitles the PIP insurer to do,<sup>119</sup> or from prejudice imposed by the liability insurer, as *Leader National* entitles the PIP insurer to do.<sup>120</sup>

The effect of the *Mahler* court's misapplication of the common fund doctrine, then, is to completely disregard the importance of preserving the PIP insurer's reimbursement interest, as it provides the PIP insurer virtually no means of protecting that interest. Thus, while the court fails to discuss the practical significance of its decision, it has, in reality, completely abrogated the underlying guarantees to insurers apparent in its earlier decisions.

#### IV. CONCLUSION

Although many premium payers typically hold some resentment toward their insurers, an understanding of insurance as a system of risk management reveals that in order for the system to best serve its insureds as an effective institution, it must be free to pursue its interests in the most efficient fashion. As Spencer Kimball relates, "By the nature of their business, healthy insurers have a copious cash flow and therefore tend to be perceived erroneously as money trees, rather than in their true nature as conduits by which money is transferred from a large class of premium payers to a smaller class of claimants."<sup>121</sup> While claimants must have their day, reducing the transactional costs of settling claimants' awards will benefit that larger and equally important class, the premium-paying public.

Allowing plaintiffs' attorneys to collect attorneys' fees for recovering an insurer's PIP interest against that insurer's will is inefficient and a detriment to premium-payers. Awarding such fees might marginally facilitate the securing of representation for some plaintiffs by allowing attorneys to take a portion of both general and special damages after doing the same amount of work, effectively enabling them to kill two birds with one stone. However, any such benefit is counterbalanced by the enormous burden on premium-payers, who will ulti-

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119. See *supra* Section II.D.1 for a discussion of the holdings of this case.

120. See *supra* Section II.D.1 for a discussion of this case.

121. SPENCER L. KIMBALL, CASES AND MATERIALS ON INSURANCE LAW 7 (1992).

mately subsidize this windfall to the plaintiffs' bar if the Washington courts continue to apply the rule of *Mahler*.<sup>122</sup>

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122. Divisions II and III of the Washington Court of Appeals have upheld the rule regarding attorney's fees articulated in *Mahler*. See *Peterson v. Safeco Ins. Co. of Illinois*, 96 Wash. App. 254, 976 P.2d 632 (1999); *Deturk v. State Farm Auto. Ins. Co.*, 94 Wash. App. 364, 967 P.2d 994 (Wash. App. 1998). See also *Harwood v. Group Health Northwest*, 93 Wash. App. 569, 970 P.2d 760 (1999) (applying the reasoning of *Mahler* to the recovery of a health insurer's subrogation interest.) In *Harwood*, Division III further extended the holding of *Mahler* such that it no longer even requires the plaintiff to show that the insurer was ostensibly a "benefited party":

[T]he better rule is that if an insurance company contracts with an insured to have a subrogation right to any recovery the insured makes against a third party, and that contract included language requiring the insurer to share the expense of recovery, the insurer should have to help pay attorney fees for the legal work done to make that recovery. No benefit to the insurer needs to be shown.

*Id.* at 576, 970 P.2d at 764.